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## Free Trade Area of the Americas: Potential Advantages For U.S. Agriculture

At the Second Summit of the Americas scheduled for April 1998 in Santiago, Chile, formal negotiations are set to begin on formation of a Free Trade Area of the Americas (FTAA) by the year 2005. President Clinton and the leaders of 33 other Western Hemisphere nations had pledged to negotiate an FTAA at the initial summit held in Miami in December 1994.

The Americas include key markets for U.S. agricultural exports, major suppliers of agricultural imports for the U.S. market, and strong U.S. competitors in certain agricultural markets. U.S. interest in forming an FTAA stems in part from the broad goal of fostering economic and political stability in the hemisphere and also from the desire to secure more open and transparent rules for U.S. trade and investment in the rapidly growing markets of Latin America (AO March 1998, January-February 1997).

Analysis by USDA's Economic Research Service (ERS) indicates that for the U.S. agricultural sector, both exports and imports would be higher with U.S. membership in an FTAA, and exports and imports would be lower if an FTAA were

formed that excluded the U.S. While U.S. membership would result in a net addition in the value of agricultural imports (the additional imports would exceed additional exports), the ERS analysis demonstrates that an assessment of trade agreements simply in terms of net trade flows can be misleading; in terms of farm income, the U.S. agricultural sector would be slightly better off within an FTAA than outside it.

The U.S. has played an active role in preparations for FTAA negotiations. How the FTAA evolves—and particularly, whether or not the U.S. joins—may have important implications for the U.S. economy. But pending congressional approval of “fast track” negotiating authority for the administration, the other prospective FTAA members would not likely be willing to negotiate because without this authority, the U.S. Congress could change elements of the agreement before ratification (AO November 1997).

### *The Americas As Trade Partners*

Agricultural trade in the Americas is governed by an increasingly complex network of regional trade agreements as well as

the parameters of World Trade Organization (WTO) rules. About 40 regional and bilateral agreements are operating in the Americas, and at least another dozen are currently under negotiation. Almost every country in the hemisphere belongs to one or more comprehensive regional trade agreements, and several countries, notably Chile, maintain extensive networks of bilateral agreements. The hemisphere's five most comprehensive agreements are the North American Free Trade Agreement (NAFTA), the Mercado Común del Sur (MERCOSUR), the Andean Group, the Central American Common Market (CACM), and the Caribbean Community and Common Market (CARICOM).

For every regional group in the hemisphere except the Southern Cone, or MERCOSUR (Argentina, Brazil, Paraguay, and Uruguay, with Chile and Bolivia as associates), the U.S. is a critical source of agricultural products. Total U.S. agricultural exports to Western Hemisphere nations in 1997 amounted to slightly over \$17 billion, or about 25 percent of all U.S. agricultural exports. The U.S. supplies 66 percent of agricultural imports for its NAFTA partners Canada and Mexico, 48 percent for Central America, 35 percent for the Caribbean, and 27 percent for the Andean Group (Bolivia, Colombia, Ecuador, Peru, and Venezuela). Only 11 percent of MERCOSUR's agricultural imports come from the U.S.

U.S. market shares for most commodities follow the same general order—highest in NAFTA, followed by Central America, the Caribbean, and the Andean Group, with the lowest U.S. shares in MERCOSUR. But the *magnitude* of U.S. market shares varies considerably by commodity. For example, U.S. producers supply more than 65 percent of the hemisphere's imports of poultry, coarse grains, and oilseeds, but less than 15 percent of dairy product and raw sugar imports.

The hemisphere is also a key source of U.S. agricultural imports, supplying about 50 percent of the U.S. total, valued at \$19.7 billion. NAFTA partners alone supply 30 percent of U.S. agricultural imports, with 20 percent split fairly evenly among Central American, MERCOSUR,

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### Nearly Every Western Hemisphere Nation Belongs to a Major Trade Bloc



and Andean countries. The Caribbean supplies only about 1 percent of total U.S. agricultural imports—primarily sugar.

#### *Measuring the Effects Of an FTAA*

Economists classify regional trade agreements as “second best” policies because, unlike global agreements, regional agreements discriminate between members and

outsiders. By reducing or eliminating trade barriers among a group of countries, a regional agreement may open new trade channels in goods which the members produce cheaply and efficiently. This is called “trade creation.” When trade creating liberalization occurs, capital and other resources used in production are reallocated toward more efficient uses—e.g., toward crops that grow well in a particular climate, or toward industries that are

competitive. This raises returns on investments and improves the overall economic well-being or “welfare” of the members. This welfare gain can increase members’ demand for all goods—including goods made by outsiders—providing an additional boost to global economic welfare.

On the other hand, if a regional agreement shelters high-cost producers within the group and excludes lower-cost goods from outside the area, this is called “trade diversion.” Trade diversion leads to less efficient allocation of resources in the global economy, and directly harms countries outside the agreement. It may, if severe enough, even hurt members. If the trade diversion is not too severe, however, it may benefit members more than it hurts outsiders, so that the net effect on the world economy is positive.

A particular trade agreement, like the FTAA, is likely to have both trade-creating and trade-diverting effects. Whether the agreement is beneficial—for members, outsiders, or the world as a whole—depends on which effect dominates.

As a member of a hemispheric FTAA, the U.S. would be likely to increase trade with other countries in the hemisphere. Productive resources would be reallocated within the U.S. economy toward more competitive sectors as producers take advantage of the new export opportunities. Rising imports would challenge the less competitive sectors and further encourage the reallocation of resources toward more competitive sectors. While the less competitive sectors of the U.S. economy would decline in an FTAA, gains in the competitive sectors would more than offset those losses.

As an outsider, the U.S. could be helped or hurt by formation of an FTAA. If trade creation dominates, the resulting improvements in economic efficiency and welfare for the members could increase trade with outsiders as well. In this case, the U.S. would be expected to benefit even as an outsider. On the other hand, if trade diversion dominates and U.S. exports are blocked, the U.S. would clearly be hurt.

Because economic theory alone cannot determine how a particular agreement might affect the U.S. economy, empirical

## Trade Agreements in the Americas

The largest and most comprehensive regional trade agreement in the hemisphere is the North American Free Trade Agreement (NAFTA) among the U.S., Canada, and Mexico. Under NAFTA, which went into effect January 1, 1994, the member nations have eliminated almost all agricultural trade barriers among themselves, with the more sensitive barriers with Mexico being phased out by 2008.

The MERCOSUR agreement among Argentina, Brazil, Paraguay, and Uruguay is second to NAFTA in total population and gross domestic product of member nations. MERCOSUR began in 1991, and by 1995 it had eliminated almost all agricultural trade barriers among members, although certain products are being gradually liberalized. The few remaining barriers for agricultural trade among MERCOSUR members will be phased out by 2013—except for sugar, which is still under negotiation.

The MERCOSUR countries adopted a common external tariff for most agricultural products in 1995, with longer transition periods for sensitive products. The common external tariff is less than 20 percent for most agricultural products, with an average of about 14 percent. MERCOSUR is expanding rapidly, having added Chile and Bolivia as associate members in 1996, and potential agreements with many other countries in the region—including Canada, Mexico, and the Andean Group—are under discussion.

The Andean Pact among Bolivia, Colombia, Ecuador, Peru, and Venezuela was established in 1969 and was revived as the Andean Group in the early 1990's. The Andean Group is adopting a common external tariff for products from non-member countries, consisting of four tariff levels: 5, 10, 15, and 25 percent. However, Bolivia requested and has been granted permission to apply only the two lower tariff rates, and Peru applies only the two higher tariff rates.

Andean Group countries also apply a price band system for many agricultural imports, so applied tariffs may be adjusted up or down to compensate for variations between international and domestic prices. Products covered by the system are palm oil, soybean oil, rice, sugar, barley, milk, corn, soybeans, wheat, chicken, and pork. As noted above, Bolivia reached a bilateral agreement with MERCOSUR in 1996, and the rest of the Andean Group is currently negotiating with MERCOSUR.

The Central American Common Market (CACM) and the Caribbean Community and Common Market (CARICOM)

encompass most of the remaining countries in the hemisphere. Like the Andean Pact, the CACM and CARICOM agreements were moribund for many years following their beginnings in the 1960's, before being revitalized in the early 1990's.

The CACM—among El Salvador, Guatemala, Honduras, Nicaragua, and Costa Rica—seeks to eliminate trade barriers among members and to establish a common external tariff of no more than 15 percent for final goods and to 0 percent for raw materials. CARICOM—among Antigua, Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Kitts-Nevis-Anguilla, St. Lucia, St. Vincent, and Trinidad and Tobago—has similar goals, but is moving more slowly than the CACM.

By 1995, the CACM had eliminated barriers on internal trade for all but seven agricultural products. The CACM's progress in establishing a common external tariff has been uneven, with El Salvador moving more quickly than the other members. External tariffs for agricultural products currently range from 0 to 20 percent, with about half of all agricultural products carrying the highest rate.

The three NAFTA signatories have a number of preferential arrangements with other countries in the hemisphere. The U.S. grants preferential access for agricultural imports from most of the smaller economies in the region under nonreciprocal agreements such as the Caribbean Basin Initiative and the Andean Trade Preference Act. These agreements offer preferential access to the U.S. market for most countries in the hemisphere with the important exceptions of Argentina, Brazil, and Chile.

Canada also provides trade preferences for most of the smaller countries in the hemisphere, has a bilateral agreement with Chile, and is negotiating a bilateral agreement with MERCOSUR. The Canadian agreement with Chile covers most agricultural products, but it exempts the Canadian dairy and poultry sectors and allows Chile to maintain its system of price bands (variable tariffs) for wheat, flour, vegetable oils, and sugar.

Mexico has been aggressive in pursuing regional and bilateral agreements throughout the hemisphere. In addition to its NAFTA membership, Mexico belongs to the Group of Three along with Colombia and Venezuela, and has agreements with Chile and MERCOSUR.

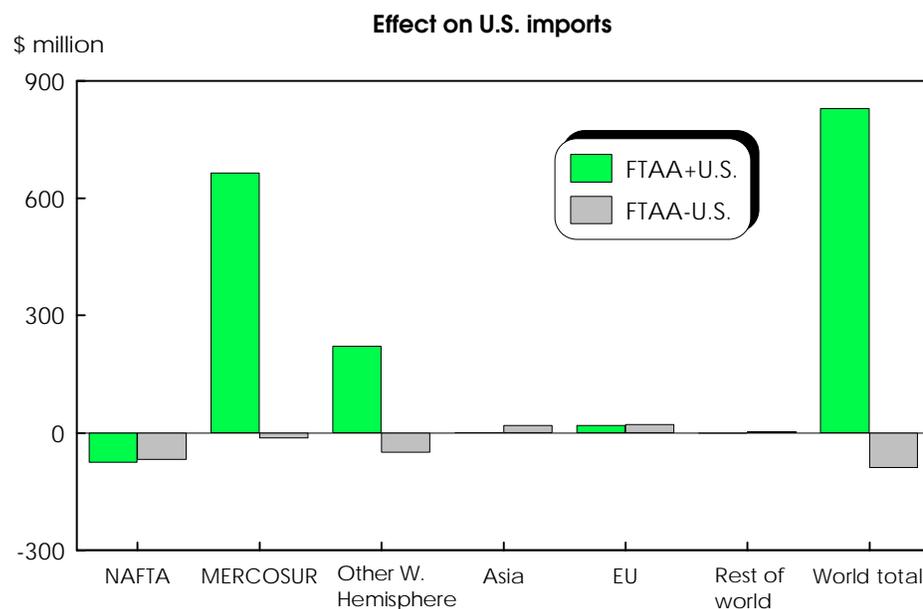
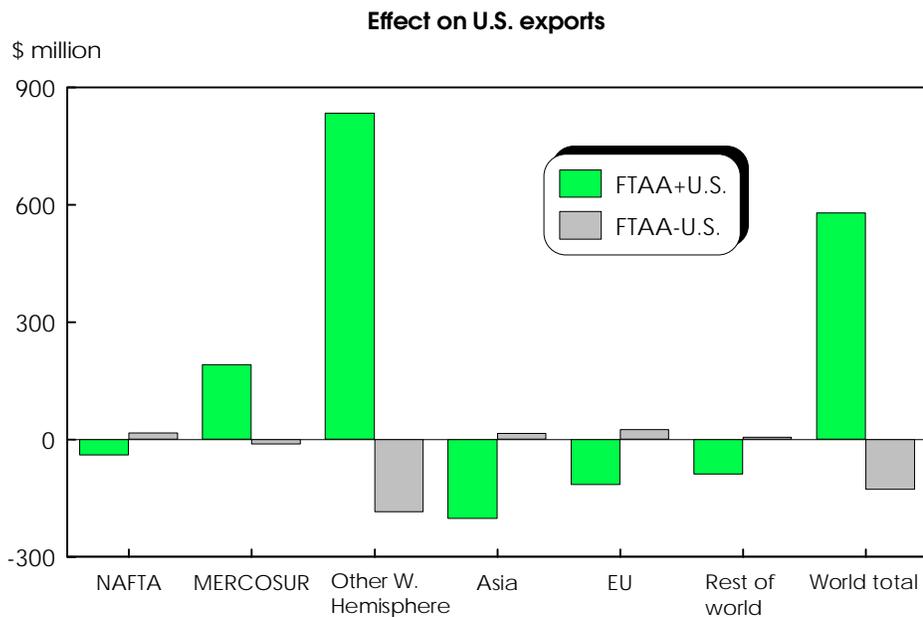
analysis is needed to clarify the issue. Empirical analysis of the implications of an FTAA for U.S. agriculture—with U.S. participation and without—is provided using a model developed by ERS. This global computable general equilibrium

model was used to isolate the effects of an FTAA from the other policy changes that are taking place in the hemisphere.

A “base” scenario was developed to represent a stylized view of agricultural production and trade in the Americas and with the rest of the world under full implementation of existing policies. Specifically, NAFTA, MERCOSUR

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### U.S. Agricultural Trade Would Gain with FTAA Membership



Differences from base scenario as result of formation of an FTAA, with and without U.S. membership. Base scenario: Total U.S. agricultural exports \$59.3 billion; total U.S. agricultural imports \$28.8 billion.

Economic Research Service, USDA

(including Chile), and the Uruguay Round agreement of the General Agreement on Tariffs and Trade are fully implemented in the base scenario. The model takes into account economic activity in both the agricultural and nonagricultural sectors.

Building on the base scenario, ERS then constructed two different scenarios under

a hemispheric free trade agreement. Under the first, all countries in the Western Hemisphere *except* the U.S. eliminate most trade barriers among themselves, while trade policies between each of those countries and the U.S. remain unchanged. The U.S. remains a member of NAFTA, but the NAFTA partners also join the FTAA.

Under the second FTAA scenario, the hemisphere-wide agreement eliminates most trade barriers among all the Americas, *including* the U.S. The ERS analysis measured how U.S. agricultural trade under each of the two FTAA scenarios would differ from the base scenario. It is important to note that the scenarios discussed here are *simulations* of what would occur under specific policy assumptions. They do not represent observed data for any specific year. A Free Trade Area of the Americas that *includes* the U.S. (FTAA+U.S.) would result in about \$580 million (real value) in additional exports for U.S. agriculture compared with the base scenario—a difference of 1 percent—and \$830 million more agricultural imports for U.S. consumers—3 percent.

The net increase in U.S. agricultural imports does not imply that U.S. agriculture would be hurt by the agreement. Actually, because freer trade promotes more efficient use of productive resources in the economy, U.S. agricultural income would be slightly higher under the FTAA compared with the base (\$180 million or less than 0.1 percent).

In the FTAA+U.S. scenario, U.S. agricultural exports to Central America, the Caribbean, and the Andean countries are 30 percent higher than the base scenario, and show the greatest gains in terms of value. U.S. exports to MERCOSUR are 50 percent higher. U.S. exports to NAFTA would be slightly lower (less than 1 percent), as U.S. exporters gain more favorable access to other markets in the hemisphere.

U.S. imports from MERCOSUR would be 30 percent greater in the FTAA+U.S. scenario, and purchases from Central America, the Caribbean, and Andean countries would be 6 percent above the base scenario. Imports from NAFTA and the regions outside the hemisphere would be slightly lower.

On the other hand, an FTAA that *excludes* the U.S. (FTAA-U.S.) could cost the agricultural sector about \$130 million per year in lost exports (2 percent). Farm income shrinks by \$50 million, or less than 1 percent compared with the base.

## About the ERS Model

The model used in this analysis was developed by ERS and the University of Minnesota. The data used in this global computable general equilibrium model come from the Global Trade Analysis Project (GTAP), version 3. The model is static, and is global in the sense that all regions of the world are covered, and production and consumption decisions in each region are consistent with economic theory.

Trade flows among regions are multilateral in the model, and world prices are determined by world market-clearing conditions—in other words, demand for each commodity in the world has to equal its supply. Values are in real terms (1992 dollars). The general equilibrium feature of the model means that resources can move among sectors—for example, land can be switched between crops, and labor can move between agricultural and nonagricultural sectors.

The country/regional aggregations in the model include: the U.S., Canada, Mexico, Argentina, Brazil, Chile, Other Western Hemisphere, EU-15, Asia, and Rest of World. The agricultural sector is represented by the following commodity aggregations: rice, wheat, other grains (corn, barley, sorghum), nongrain crops (oilseeds, fresh fruits and vegetables, unrefined sugar, and cotton), livestock, meats, dairy and dairy products, beverages and tobacco, and other processed food products. The rest of the economy is represented by an aggregate manufacturing sector (excluding food processing) and a services sector.

The estimated impacts of an FTAA depend critically on the initial levels of trade protection and the degree of trade liberalization assumed in the model. Trade restrictions for the countries and commodities in the model are represented as *ad valorem* tariffs. These initial tariffs are approximations, because some of the country and commodity categories in the model represent aggregations and because some nontariff barriers are not included in the data.

For each of the scenarios examined, the assumed degree of trade liberalization is simulated by reducing the initial tariffs. Because full trade liberalization does not necessarily imply the elimination of all trade barriers—sanitary and phytosanitary standards, for example—the initial level of protection in the model is not always reduced to zero even though the pure tariff component is assumed to be eliminated.

Under the FTAA-U.S. scenario, U.S. exports to Central America, the Caribbean, and the Andean Group would be \$180 million, or almost 7 percent below the base scenario. This occurs

because other major exporters in the hemisphere gain preferential access to these markets while barriers against the U.S. remain intact. U.S. exports to the NAFTA partners are not harmed, howev-

er, because the U.S. retains open access to these markets even after they join the FTAA. Some, but not all, of the losses in U.S. exports to the hemisphere would be offset by gains in Asia, Europe, and the rest of the world.

In addition to the reduction in U.S. agricultural exports, imports would be very slightly lower—by about \$90 million or less than 1 percent—as tariff reductions in member countries bid products away from the U.S. market. Imports from NAFTA partners would decline the most as Canada and Mexico gain access to other markets in the hemisphere, but imports from Central America, the Caribbean, and the Andean countries would also be lower. U.S. imports from Asia and Europe would be greater than the base, filling part, but not all, of the gap.

Although the potential economic gains for U.S. agriculture are small, ERS analysis clearly shows that the sector would be better off by joining an FTAA than by remaining on the sidelines. Moreover, by improving the economic well-being of the trade partners, an FTAA could increase their demand for agricultural (and other) products. An FTAA could also simplify the complex system of regional and bilateral trade preferences emerging in the hemisphere and could ensure that U.S. exporters gain or retain access to regional markets on a comparable basis with other exporters' access. Further, an FTAA could help countries "lock in" the economic reforms they have already adopted, improving the long-term outlook for growth and stability in the hemisphere. *Terri Raney (202-694-5235), Xinshen Diao, and Agapi Somwaru* [traney@econ.ag.gov](mailto:traney@econ.ag.gov) 

For a more comprehensive analysis of a potential FTAA on the agricultural sector of the U.S. and other countries in the hemisphere, look for ***Free Trade in the Americas***, upcoming from ERS. The report will assess the effects of trade liberalization on economic growth in the hemisphere, and provide a more detailed analysis of the commodity-level impacts.